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IN THE
Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF COUNCIL OF INSTITUTIONAL INVESTORS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

JEFFREY P. MAHONEY
COUNCIL OF INSTITUTIONAL INVESTORS
888 17th Street, N.W.
Suite 500
Washington, D.C. 20006
(202) 822-0800

MARK C. HANSEN
PRIYA R. AIYAR
Counsel of Record
KELLOGG, HUBER, HANSEN, TODD, EVANS & FIGEL, P.L.L.C.
1615 M Street, N.W.
Suite 400
Washington, D.C. 20036
(202) 326-7900

Counsel for Amicus Council of Institutional Investors

June 11, 2007

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INTEREST OF *AMICUS CURIAE*[1]

The Council of Institutional Investors ("Council") is a not-for-profit association of more than 130 public, labor, and corporate pension funds with assets exceeding $3 trillion. Its members are major long-term shareowners with duties to protect the retirement assets of millions of American workers. The Council is an advocate for strong corporate governance standards. Its members seek to protect plan assets through proxy votes, shareowner resolutions, pressure on regulators, discussions with management, and, when necessary, litigation. The Council has previously appeared as an *amicus* in cases affecting shareowner rights. *See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484 (U.S., argued Mar. 28, 2007); *Devlin v. Scardelletti*, 536 U.S. 1 (2002); *CalPERS v. Felzen*, 525 U.S. 315 (1999).

The interests of the Council and its members are directly implicated by this case. Congress has recognized that institutional investors are America's largest shareowners and "'have the most to gain from meritorious securities litigation.'" H.R. Conf. Rep. No. 104-369, at 34 (1995) (quoting testimony of Maryellen Andersen, then-treasurer of the Council), *reprinted in* 1995 U.S.C.C.A.N. 730, 733. The Council thus has a strong interest in protecting investors' ability to obtain redress from secondary actors who commit securities fraud.

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[1] Pursuant to Supreme Court Rule 37.6, counsel for *amicus* represents that it authored this brief and that no person or entity other than *amicus* or its counsel made a monetary contribution to the preparation or submission of the brief. Counsel for *amicus* represents that counsel for all parties have consented to the filing of this brief. Petitioner has filed with the Clerk a letter granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of respondents to the filing of this brief has been filed with the Clerk.

SUMMARY OF ARGUMENT

The Council does not take a position on the precise legal standard for determining when a so-called "secondary actor" – such as a law firm, accounting firm, investment bank, or counterparty in a fraudulent transaction – is a primary violator of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5. The Council believes, however, that the strict test for primary liability endorsed by some lower courts would have undesirable policy consequences. Under that test, a secondary actor is a primary violator of § 10(b) and Rule 10b-5 only if it makes a misstatement that is publicly attributed to the actor at the time of the plaintiff's investment decision, owes a fiduciary duty to the plaintiff investors, or illegally trades in the issuer's securities. *See, e.g., Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) ("[A] secondary actor cannot incur primary liability under the [Securities] Act for a statement not attributed to that actor at the time of its dissemination."); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) ("[I]n order for the defendant to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made.").[2]

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[2] *See also In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006) (deception within the meaning of § 10(b) includes only misstatements or failure to disclose by one with a duty to disclose, while manipulation includes only illegal trading in the issuer's securities), *cert. granted*, 127 S. Ct. 1873 (2007) (No. 06-43); *Regents of Univ. of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 389-91 (5th Cir. 2007) (a "deceptive" device must involve breach of a duty of disclosure, while "manipulation" requires that the defendant act directly in the market for the relevant security), *petition for cert. pending*, No. 06-1341 (U.S. filed Mar. 5, 2007); *id.* at 394 (Dennis, J., concurring in the judgment) (according to the *Credit Suisse* majority and *Charter Communications*, secondary actors cannot be primary violators unless they "(1) directly make public misrepresenta-

Adoption of the strict test would undercut lessons learned in the aftermath of recent financial scandals regarding the complexity of securities fraud today and the importance of deterring secondary actors from participating in fraud. *See* Point I, *infra*. It would give accountants, investment bankers, lawyers, and other third parties a "safe harbor" for fraud so long as they do not publicly announce their involvement with an issuer's misstatements. *See* Point II, *infra*. Contrary to the reasoning of some courts, the strict test is not required to stem a tide of frivolous litigation against secondary actors. *See* Point III, *infra*. Finally, neither lawsuits against issuers themselves nor SEC enforcement will adequately compensate investors in the face of the strict test. *See* Point IV, *infra*.

ARGUMENT

I. ADEQUATE DETERRENCE OF SECONDARY ACTORS IS CRUCIAL TO PREVENTING FRAUD

A common thread in the massive financial scandals of recent years – such as Enron, WorldCom, Tyco, Adelphia, and Global Crossing – is the involvement of accountants, lawyers, investment bankers, and financial advisers in structuring complex transactions designed to falsify companies' financial statements. *See, e.g.*, Joel S. Demski, *Corporate Conflicts of Interest*, 17 J. Econ. Persp. 51, 65-66 (2003) ("Enron carried out countless highly complex and carefully crafted financial transactions. These all involved selling of additional financial services by consultants, attorneys and investment banks. In many cases, these transactions were designed with no apparent purpose other than manipulating recorded debt and earnings and often provided an opportunity for a financial institution to collect fees on both sides of a transaction.").

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tions; (2) owe the issuer's shareholders a duty to disclose; or (3) directly 'manipulate' the market for the issuer's securities through practices such as wash sales or matched orders").

While large-scale securities fraud is not a new phenomenon, recent scandals have been particularly devastating because they illustrate the failure of outside professionals to check corporate management. *See, e.g.*, John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 Bus. Law. 1403, 1404-05 (2002) (in contrast to prior frauds, which "have not generally disturbed the overall market[,] . . . Enron has clearly roiled the market"; "[b]ehind this disruption lies the market's discovery that it cannot rely upon the professional gatekeepers – auditors, analysts, and others – whom the market has long trusted to filter, verify and assess complicated financial information"). Adoption of the strict test would ignore the role of secondary actors in protecting the integrity of securities markets; the evidence that increased profits from fraud and decreased risks of liability led secondary actors to fail in that role; and the need to establish adequate deterrence of secondary actors.

A. Secondary Actors' Function as Gatekeepers

Academics as well as policymakers have recognized the function of secondary actors as "gatekeepers" in the securities markets. *See, e.g.*, Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, *The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program*, Speech at UCLA School of Law (Sept. 20, 2004) (describing "the auditors who sign off on companies' financial data" and "the lawyers who advise companies on disclosure standards and other securities law requirements" as "gatekeepers" and "sentries of the marketplace"), *available at* http://www.sec.gov/news/speech/spch092004smc.htm. These third-party professionals verify companies' statements for investors and enable companies to execute transactions. Their involvement may be public – *e.g.*, certifying financial statements and signing opinion letters – as well as non-public – *e.g.*, designing transactions, drafting press releases and prospectuses, and producing non-public opinions for issuers and underwriters.

Secondary actors have long been regarded as a critical check on fraud by corporations. Executives may face overwhelming temptation to inflate corporate profits through fraud, especially if their compensation is largely equity-based. *See, e.g.*, Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation*, 35 Wake Forest L. Rev. 123, 132-34 (2000) (during the 1990s, compensation of both CEOs and directors became more dependent on stock price). Secondary actors, however, have less motive to participate in fraud. A prominent accounting firm, law firm, or investment bank logically should not sacrifice the reputational capital on which it trades for the fees associated with a single engagement. Thus, requiring secondary actors to approve corporate statements and to facilitate transactions ought to minimize fraud, because these actors are easier to deter than management. *See, e.g.*, *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) ("An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses [Ernst & Whinney] would suffer from a perception that it would muffle a client's fraud. . . . E & W's partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with Continental."); *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) ("[I]t seems extremely unlikely that Coopers & Lybrand was willing to put its professional reputation on the line by conducting fraudulent accounting work for URCARCO."). *See generally* Reinier Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. Econ. & Org. 53 (1986).

B. Explaining Gatekeeper Failure

The business scandals of recent years, however, revealed that reputational incentives were frequently inadequate to deter secondary actors from participating in fraud. *See, e.g.*, John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Inde-*

pendence and the Governance of Accounting 2-5 (Columbia Law School, The Center for Law and Economics Studies, Working Paper No 191, May 21, 2001), *available at* http://papers.ssrn.com/id=270944; Hillary A. Sale, *Banks: The Forgotten Partners in Fraud*, 73 U. Cin. L. Rev. 139, 140-41 (2004). The failure of professional gatekeepers was reflected not only in a few high-profile cases, but also in a decline in the overall quality of financial reporting. Ten percent of publicly listed companies restated their earnings because of accounting irregularities between 1997 and 2001.[3] Restatements continued to rise between 2002 and 2005.[4] These restatements were not technical; the stock prices of restating companies between 1997 and 2001 suffered immediate, market-adjusted declines of more than 10%. *See* 2002 GAO Report at 24-25; *see also* 2006 GAO Report at 23-24 (market capitalization of restating companies between 2002 and 2005 decreased an estimated $36 billion in the days surrounding a restatement, adjusted for overall market movements).

One explanation of gatekeeper failure is that the potential profits to secondary actors that committed fraud were greater than recognized in cases like *DiLeo* and *Melder*. For example, accountants' incentive to acquiesce in clients' demands was not just their audit fees, but also their desire to retain consulting revenue from audit clients that could easily threaten to take their consulting business elsewhere. *See, e.g.*, Coffee, 57 Bus. Law. at 1410-11

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[3] *See* United States General Accounting Office, Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges* 15 (Oct. 2002) ("2002 GAO Report"), *available at* http://www.gao.gov/new.items/d03138.pdf.

[4] *See* United States Government Accountability Office, Report to the Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities* 11 (July 2006) ("2006 GAO Report") (finding a five-fold increase in the number of restatements between 1997 and 2005), *available at* http://www.gao.gov/new.items/d06678.pdf.

& n.36 ("Consulting fees paid by audit clients exploded during the 1990s."); *see also* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation*, 95 Nw. U. L. Rev. 133, 186-217 (2000) (identifying a host of reasons why it may be economically rational for individual auditors and auditing firms to participate in fraud).[5] Moreover, the advent of new limited liability corporate forms reduced the incentives of partners to monitor one another, decreasing the predictive value of focusing on the reputation of a firm as a whole. *See* Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 Vill. L. Rev. 1167, 1170-72, 1186 (2003).

Like accounting firms, many investment banks also profited from client business at the same time that they allegedly neglected due diligence obligations with respect to clients' other transactions. For example, Citigroup and Salomon Smith Barney allegedly serviced more than $3 billion in loans to a partnership owned by the family that controlled Adelphia, while leading public offerings of Adelphia stock. *See* Deborah Solomon, *Salomon Draws Focus by SEC Over Adelphia*, Wall St. J., June 5, 2002, at C1. With respect to Enron, bank executives allegedly invested their own funds in off-balance-sheet special-purpose entities, while designing and profiting from sham transactions that were intended to let Enron book revenue when it was actually incurring debt. *See In re Enron Corp. Sec. Litig.*, 235 F. Supp. 2d 549, 637-56, 695-704 (S.D. Tex. 2002); Charles Gasparino & Tom Hamburger, *Congress Broadens Probe of Enron Fall and Wall Street Role*, Wall St. J., Mar. 7, 2002, at C1. Financial institutions' practice of making loans in exchange for underwriting and other fees may be on the rise. *See, e.g.*, Jathon Sapsford, *Executives See Rise in 'Tying' Loans to Other Fees*, Wall St. J., June 9, 2004, at A1; *see also* Frank Part-

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[5] Congress addressed this problem in the Sarbanes-Oxley Act of 2002. *See infra* p. 9.

noy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 Wash. U. L.Q. 491, 524-25 (2001) ("[A]bundant anecdotal evidence suggests that investment banks engage in potentially reputation-depleting activities in order to maximize profits. . . . Substantial agency costs at investment banks prevent managers from restraining lower-level employees who have incentives to deplete the firm's reputation to increase their own profits.").

An increase in available profits, however, is not the only explanation for participation in fraud by secondary actors during the 1990s and early 2000s. As Professor Coffee has observed, those years also saw a marked decrease in the risk of liability for such actors because of decisions by the Court and Congress. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 318-21 (2004) (explaining that *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), shortened the statute of limitations applicable to securities fraud, while *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), eliminated a private right of action for aiding and abetting). In 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA") and, in 1998, the Securities Litigation Uniform Standards Act ("SLUSA"). PSLRA imposed a heightened pleading standard in securities fraud class actions, *see* § 101, 109 Stat. 737-49; replaced joint and several liability with proportionate liability, *see* § 201(a), 109 Stat. 758-62; eliminated securities fraud as a predicate for RICO claims for which plaintiffs could seek treble damages, *see* § 107, 109 Stat. 758; and created a safe harbor for forward-looking statements, *see* § 102, 109 Stat. 749-56. SLUSA required class actions alleging securities fraud to proceed in federal court under the PSLRA, rather than in state court. These developments combined to reduce the risk that secondary actors that participated in fraud would be held liable by investors. *See infra* pp. 16-18 (describing

the decline in securities litigation against secondary actors following the legal developments of the 1990s).

C. The Need for Adequate Deterrence

Thus, a central lesson of recent financial scandals is that the cost-benefit analysis for secondary actors tipped too far in the direction of encouraging fraud. Congress took steps to address the benefit side of this equation when it enacted the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley attempted to eliminate problematic incentives for some secondary actors by, for example, barring accountants from providing certain consulting services to audit clients, *see* 15 U.S.C. § 78j-1(g). Congress, however, did not address other categories of secondary actors, such as investment bankers. *See* Sale, 73 U. Cin. L. Rev. at 141 (Sarbanes-Oxley "ignores one key set of gatekeepers – bankers"); *see also* Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 Vill. L. Rev. 1097, 1101 (2003) (Sarbanes-Oxley's reporting-up obligation for lawyers "is unlikely to be an effective response to the types of problems experienced at Enron").

Moreover, Sarbanes-Oxley did not focus on the cost side of the decision-making calculus for secondary actors by strengthening deterrents against fraud. *See, e.g.*, Assaf Hamdani, *Gatekeeper Liability*, 77 S. Cal. L. Rev. 53, 55 (2003) ("despite the apparent consensus that insufficient deterrence of gatekeepers (such as accountants) is to blame for debacles like Enron, there has been virtually no attempt to go down the simple path of making gatekeeper liability more stringent") (footnote omitted); Coffee, 84 B.U. L. Rev. at 337 (though Sarbanes-Oxley reduced expected benefits from participation in fraud, expected costs remain reduced as well). In the wake of Enron and other scandals, commentators have suggested various methods of achieving more adequate deterrence of gatekeepers, for example, a regime of stricter liability. *See, e.g.*, Partnoy, 79 Wash. U. L.Q. at 546-47 (proposing modified strict liability for gatekeepers based on material misstatements

or omissions in offering documents; explaining that, under this proposal, investors who prevail against an issuer for securities fraud would automatically win damages against the relevant gatekeepers, with the only liability limitations being those placed through indemnification or insurance agreements). Whether strict liability, negligence-based liability, or knowledge-based liability for gatekeepers is appropriate may depend on judgments about how effectively gatekeepers can prevent wrongdoing. Where the costs of prevention are unknown or large, a knowledge-based liability standard may be a safe approach. It prevents at least some wrongdoing at low cost, and it allows the costs of gatekeeper compliance to be borne by clients that gatekeepers know to be wrongdoers. *See* Hamdani, 77 S. Cal. L. Rev. at 104.

Without taking a position on what standard of liability best serves public policy, it would certainly undermine the goal of adequate deterrence to eliminate even *knowledge*-based liability for fraud – the *laxest* standard for gatekeepers – simply because no fraudulent statement is publicly attributed to a secondary actor. Secondary actors already confront significant incentives to participate in fraud, as the profits allegedly derived by the investment bank defendants in the Enron litigation illustrate. Allowing such actors to insulate themselves against legal liability simply by avoiding a public announcement of involvement would create overwhelming temptation to enable fraud. Even otherwise well-intentioned secondary actors might acquiesce in a client's demands to consummate a fraudulent transaction or to issue a fraudulent statement in such circumstances. *See, e.g.*, Testimony of Thomas Donaldson, Mark O. Winkelman Professor, The Wharton School, University of Pennsylvania, *Penalties for White Collar Crime: Are We Really Getting Tough on Crime?*, Before the S. Comm. on the Judiciary, 107th Cong. (July 10, 2002) ("Corporate Watergates typically involve scores and sometimes hundreds of people inside the corporation, and all too often, scores of people outside the corporation, i.e., in institutions such as accounting firms, investment

banks, and law firms. The plain truth is that many of these thousands of people are not slime balls or bad apples but ordinary people under extraordinary pressures."), *available at* http://judiciary.senate.gov/testimony.cfm?id=310&wit_id=712.

II. THE STRICT TEST FOR PRIMARY LIABILITY WOULD CREATE A SAFE HARBOR FOR FRAUD

Both real and hypothetical examples illustrate that the strict test, under which a defendant is not a primary violator unless it signs a false statement or owes a fiduciary duty to investors, permits secondary actors to escape liability for clear fraud. At common law, participation in fraud was enough to impose joint and several liability; there was no requirement that the defendant be in privity with the victim or personally speak the misrepresentation to the victim. *See, e.g.*, 37 C.J.S. *Fraud* § 61, at 346 (1943); Restatement (Second) of Torts § 531, at 66 (1977); *see also* Robert A. Prentice, *Locating that "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. Rev. 691, 751-52 (1997) (collecting cases); *Stewart v. Wyoming Cattle Ranche Co.*, 128 U.S. 383, 388 (1888) ("[t]he gist of the action is fraudulently producing a false impression upon the mind of the other party; and, if this result is accomplished, it is unimportant whether the means of accomplishing it are words or acts of the defendant"). Commentators have observed that fraud, by its very nature, may involve hiding the true author of a mistatement. *See, e.g.*, Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 Del. J. Corp. L. 865, 889 (1995) ("The very nature of securities fraud often involves obscuring the source and interests of its authors. People can have a significant influence on how fraudulent disclosure is packaged, and hence how effective it is, without being identifiable to the victim.").

Nevertheless, under the strict test for primary liability, a secondary actor that creates and disseminates a fraudu-

lent statement, but is not publicly identified as the author of the statement, will avoid liability for fraud. It is uncontroversial that an accountant who knowingly issues a false audit opinion under his or her own name may be liable as a primary violator. *See, e.g.*, Dan Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Calif. L. Rev. 80, 107-08 (1981) (cited in *Central Bank*, 511 U.S. at 191). Yet, under the strict test, an accounting firm that designs a transaction so that a client can report it in a misleading manner, prepares a false statement regarding the transaction, and approves release of the statement will *not* be liable as a primary violator if the statement is issued to the public under the client's name, rather than the accounting firm's name.

Similarly, a law firm that creates a fraudulent disclosure for its client, using its expertise to craft the disclosure in a manner that evades unwanted attention, would not be liable. *See, e.g., Ziemba*, 256 F.3d at 1205-06 (allegations that law firm created fraudulent letters and press releases for issuance under client's name did not state a § 10(b) claim); *Rocker Mgmt., LLC v. Lernout & Hauspie Speech Prods. N.V.*, No. Civ. A. 00-5965, 2005 WL 3658006, at *11 (D.N.J. June 7, 2005) (preparation of financial statements could not give rise to primary liability where statements were not publicly attributed to defendant at time of plaintiffs' investment decisions); *In re Cascade Int'l Sec. Litig.*, 840 F. Supp. 1558, 1563-64 (1993) (lawyers' preparation of fraudulent SEC filings, press releases, and letters to shareholders, as well as their making false statements to members of the public could not give rise to primary liability in the absence of any fiduciary duty owed to plaintiff shareholders), *modified on other grounds on recon.*, 894 F. Supp. 437 (S.D. Fla. 1995). Even if a secondary actor knowingly circulates false statements to investors, inducing investors to rely on those statements, it will escape liability under the strict test if the statements are under its client's name. *See, e.g., Winkler v. NRD Mining, Ltd.*, 198 F.R.D. 355, 364-66 (E.D.N.Y. 2000) (director and public relations firm could

not be liable for drafting and disseminating releases containing false statements that were not attributed to them).

Courts that reject the strict test have similarly recognized that it would prevent them from holding liable defendants who author false statements that they know will reach investors. *See, e.g., In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 168 (D. Mass. 2002) ("Absolving an auditor who prepares, edits, and drafts a fraudulent financial statement knowing it will be publicly disseminated simply because an affiliated auditor with which it is working under a common trademark is the one to actually sign it, would stretch *Central Bank*'s holding too far."); *Carley Capital Group v. Deloitte & Touche, LLP*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) ("Under the Second Circuit standard, a secondary actor who is the actual creator and author of a material misstatement could avoid liability simply due to the concealment of its identity."); *Employers Ins. of Wausau v. Musick, Peeler, & Garrett*, 871 F. Supp. 381, 389-90 (1994) (rejecting rigid rule that accountant must certify or be named in a document to be liable for misstatements; allowing § 10(b) claim to proceed where accountants were allegedly architects of misleading prospectus), *amended on other grounds on recon.*, 948 F. Supp. 942 (S.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) ("While the investing public may not be able to reasonably attribute the additional misstatements and omissions to [Ernst & Young], the securities market still relied on those public statements and anyone intricately involved in their creation and the resulting deception should be liable under Section 10(b)/Rule 10b-5.").

The strict test would also create the perverse result that, if the author of a fraudulent statement knew it was false, but the entity under whose name the statement issued did not, no actor would be liable as a primary violator under § 10(b). For example, courts have held, both before and after *Central Bank*, that a corporation that knowingly reviews and approves false statements in an

analyst's report may be liable as a primary violator of § 10(b). Yet, under the strict test, the corporation could not be liable for statements that were publicly attributed to the analyst. *See In re ICN/Viratek Sec. Litig.*, No. 87 Civ. 4296, 1996 WL 164732, at *5, *7 (S.D.N.Y. Apr. 9, 1996) (explaining that, under the strict rule adopted by some courts, "no matter how extensive a corporation's review and approval of statements in an analyst's report, that review and approval does not imply that the corporation, in effect, has 'made' the statements in the analyst's report, for the purposes of liability under § 10(b)"; rejecting that rule where it would immunize the defendant from § 10(b) liability for reviewing and editing a report that it knew contained false statements about defendants' AIDS drug).[6]

In sum, applying the strict test, a secondary actor can escape liability for creating a fraudulent statement that it disseminates to investors, or knows will be disseminated to the market, so long as it does not announce its authorship of the statement. Such a test rewards obfuscation rather than disclosure, contrary to the aims of the securities laws. Allowing accountants, law firms, investment banks, and other secondary actors to avoid § 10(b) liability so long as misstatements do not issue under their names would enable secondary actors to profit from frauds that they mastermind while concealing their participation from the investing public. That danger is hardly hypothetical, as the evidence and allegations in the Enron litigation demonstrate. Without taking a position on the precise standard for primary liability under § 10(b), the Council respectfully suggests that the strict test would

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[6] While plaintiffs might also try to sue on an agency theory, *cf. Copland v. Grumet*, 88 F. Supp. 2d 326, 333 (D.N.J. 1999) (suggesting that, when a defendant controls the content of another actor's statement, the actor is operating as the agent of defendant), some courts have questioned the scope of agency liability under § 10(b), *see, e.g., In re Lernout & Hauspie*, 230 F. Supp. 2d at 172 (collecting cases). Moreover, if a corporation makes an ultimate decision to issue a statement under its name, it may not be the "agent" of a secondary actor.

undermine incentives for secondary actors to maintain the integrity of the securities markets.

III. FEARS OF OPENING THE FLOODGATES TO FRIVOLOUS LITIGATION ARE UNFOUNDED

Some lower courts adopting the strict test have done so partly out of concern that any other standard would open the floodgates to meritless litigation against secondary actors. For example, the Fifth Circuit admitted that its decision in the Enron litigation allowed secondary actors to "escape liability for alleged conduct that was hardly praiseworthy," but concluded that "the rule of liability must be either overinclusive or underinclusive so as to avoid what *Hundahl* called '*in terrorem* settlements' resulting from the expense and difficulty of, even meritoriously, defending this kind of litigation." *Credit Suisse*, 482 F.3d at 392 (quoting *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1363 (N.D. Tex. 1979)); *see also id.* at 393 (ascribing "a limited interpretation to the words of § 10, viewing the statute as the result of Congress's balancing of competing desires to provide for some remedy for securities fraud without opening the floodgates for nearly unlimited and frequently unpredictable liability for secondary actors"). *Hundahl* was a 1979 decision expressing worries about "strike" suits brought solely for their settlement value. 465 F. Supp. at 1363 & n.8. Similarly, *Central Bank* itself, while focusing on the text of the statute, observed that private securities litigation "'presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general,'" requiring "secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." 511 U.S. at 189 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)). The Court suggested that these litigation and settlement costs might ultimately be passed on to investors. *See id.*

A. The PSLRA Has Reduced Frivolous Litigation Against Secondary Actors

Whether or not these fears were well-grounded at the time of *Hundahl* and *Central Bank*, *see* Joel Seligman, *The Implications of Central Bank*, 49 Bus. Law. 1429, 1433-34 (1994) (arguing that *Central Bank*'s summary of policy arguments, which "relied on a single Senator's uncorroborated assertion of litigation costs and fewer than five printed pages on point in an article by Judge Winter," was "based on a mischaracterization of available evidence"), they are far less relevant today. Congress responded to exactly such concerns about "strike suits" in the PSLRA, aiming to reduce the settlement value of meritless lawsuits by permitting dismissal before costly discovery. *See* H.R. Conf. Rep. No. 104-369, at 39 & n.17, *reprinted in* 1995 U.S.C.C.A.N. 738; S. Rep. No. 104-98, at 14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 693. The pre-trial dismissal rate for securities class actions has nearly doubled since enactment of the PSLRA, while settlement sizes have increased, reflecting a higher proportion of meritorious litigation.[7] Indeed, the PSLRA's heightened pleading standard may have screened out meritorious cases in addition to frivolous ones.[8]

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[7] *See, e.g.*, Todd Foster *et al.*, NERA, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar* 4-5 (Jan. 2007), *available at* http://www.nera.com/image/BRO_Recent%20Trends_%201288_FINAL-web.pdf; Marilyn F. Johnson *et al.*, *Do The Merits Matter More? The Impact of the Private Securities Litigation Reform Act* (Univ. of Mich., John M. Olin Center for Law & Economics, Working Paper No. 02-011, 2006), *available at* http://ssrn.com/abstract=883684.

[8] *See, e.g.*, Stephen Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. Econ. & Org. (forthcoming 2007) (Am. Law & Econ. Ass'n, Am. Law & Econ. Ass'n 15th Annual Meeting, Working Paper 25, 2005), *available at* http://law.bepress.com/alea/15th/art25; Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 Ariz. L. Rev. 711, 714-15 (1996).

The PSLRA's requirement that plaintiffs plead facts giving rise to a "strong inference" of scienter is especially significant for secondary actors. While there may be facts in the public domain enabling plaintiffs to plead scienter with respect to corporate executives – *e.g.*, insider stock sales prior to the public disclosure of negative information – it will be more difficult for plaintiffs to obtain, without discovery, facts indicating intent to commit fraud on the part of secondary actors. *See, e.g.*, Coffee, 57 Bus. Law. at 1410 n.35. Another PSLRA reform with particular impact on secondary actors is the statute's substitution of proportionate for joint and several liability in certain cases. Congress was concerned about the pursuit of "deep pockets" by plaintiffs' lawyers, as well as the unfairness of imposing traditional joint liability on a secondary defendant that might be minimally culpable. *See* H.R. Conf. Rep. No. 104-369, at 37 ("Under current law, a single defendant who has been found to be 1% liable may be forced to pay 100% of the damages in the case."), *reprinted in* 1995 U.S.C.C.A.N. 736; *accord* S. Rep. No. 104-98, at 20, *reprinted in* 1995 U.S.C.C.A.N. 699. The PSLRA thus provided that a defendant would be jointly and severally liable only if the trier of fact "specifically determines that such covered person knowingly committed a violation of the securities laws." 15 U.S.C. § 78u-4(f)(2)(A). When the scienter of a secondary actor is based on recklessness, the actor will "be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that [actor]." *Id.* § 78u-4(f)(2)(B)(i). Finally, SLUSA eliminated plaintiffs' ability to avoid *Central Bank*'s prohibition on private suits for aiding and abetting – as well as the PSLRA pleading requirements – by pursuing class actions against secondary defendants under state law.

These shifts in the legal landscape have to a substantial extent protected secondary actors from liability. An SEC study of the PSLRA's impact found a decline in lawsuits against secondary defendants. *See* Office of the General Counsel, SEC, *Report to the President and the Congress on the First Year of Practice under the Private Securities*

Litigation Reform Act of 1995 (Apr. 1997) (concluding that "[s]econdary defendants, such as accountants and lawyers, are being named much less frequently in securities class actions"), *available at* http://www.sec.gov/news/studies/lreform.txt. More recent studies have confirmed that auditors and underwriters are named defendants in a very small percentage of securities class actions. *See* Cornerstone Research, *Securities Class Action Case Filings, 2006: A Year in Review* 20 (2007) (auditors and underwriters were named in 1% and 5% of cases respectively in 2006), *available at* http://www.cornerstone.com/securities/pdfs/YIR2006.pdf; Cornerstone Research, *Securities Class Action Case Filings, 2005: A Year in Review* 16 (2006) (auditors and underwriters were named in 3% and 4% of cases respectively in 2005, and in 4% and 1% of cases respectively in 2004), *available at* http://www.cornerstone.com/securities/pdfs/YIR2005.pdf; *see also* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 Colum. L. Rev. 1534, 1550 (2006) ("Because the majority of securities class actions contain at least some allegations of accounting fraud, this striking omission of auditors and other secondary actors as defendants suggests that they have been well insulated against securities fraud liability.") (footnote omitted).

Thus, the Court should not rely on any pre-PSLRA concerns regarding the need for a strict test to protect innocent secondary defendants. On the contrary, the Court should be hesitant to further immunize secondary actors that are already well-protected from liability by the PSLRA and the SLUSA. *Cf.* Coffee, *The Acquiescent Gatekeeper* at 4-5 (accounting irregularities predictably increase as litigation risks diminish).

B. Allegations of Primary Violations by Secondary Actors Are Not Presumptive Efforts To Evade *Central Bank*

Nor are lawsuits alleging primary violations by secondary actors a recent innovation that might be regarded as

a harbinger of frivolous litigation or an attempt to evade *Central Bank*. *Cf. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1511 (2006) (noting Congress's finding that state-law securities fraud suits were rare before the PSLRA, and that their proliferation reflected an effort to evade the PSLRA). *Central Bank* itself recognized that "[i]n any complex securities fraud ... there are likely to be multiple violators." 511 U.S. at 191. Moreover, prior to the acceptance of aiding-and-abetting liability in the courts of appeals, secondary actors were frequently held liable as primary violators for passing on clients' communications that they knew were false, playing integral roles in fraudulent misstatements, and participating in fraudulent schemes. *See* Prentice, 75 N.C. L. Rev. at 703-04 & nn.52-57 (collecting pre-1969 cases). Later, courts often held that theories of primary liability and aiding-and-abetting liability covered the same conduct by secondary actors. *See id.* at 704-09 & nn.58-60; *see also, e.g., Molecular Tech. Corp. v. Valentine*, 925 F.2d 910, 917-18 (6th Cir. 1991) (attorney's participation in preparing false statements could be primary and secondary wrongdoing); *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 978 (1988) (because the complaint adequately pled primary liability, "[i]t follows that the complaint adequately pleads aiding and abetting"), *vacated in part on other grounds on recon.*, 714 F. Supp. 1285 (E.D.N.Y. 1989). Thus, adoption of something other than the strict test would not lead to unprecedented expansion of liability for secondary actors.

C. Plaintiffs Must Still Prove Reliance

A final check on securities litigation against secondary actors is the requirement that plaintiffs prove reliance on a defendant's misstatement or deceptive act. *See, e.g., In re Enron*, 235 F. Supp. 2d at 588-91 (adopting SEC's proposed test, under which a secondary actor that acts with scienter and creates a misrepresentation may be liable as a primary violator, while emphasizing that plaintiffs must still prove reliance). The Council does not take a position on the precise definition of reliance the Court should

adopt. *Cf.* Brief of the SEC, *Amicus Curiae*, in Support of Positions that Favor Appellant at 21, *Simpson v. Homestore.com, Inc.*, No. 04-55665 (9th Cir. filed Oct. 21, 2004) (arguing that reliance exists when "a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction"). However, under the strict test, the elements of a primary violation are not met even when the defendant creates a misstatement and circulates it to investors who rely on it, simply because the misstatement is not attributed to the defendant. The requirement that plaintiffs rely on a fraudulent misrepresentation – as opposed to relying on attribution of the misrepresentation to a particular defendant – does not mandate such a result.

IV. ELIMINATION OF PRIVATE LAWSUITS AGAINST SECONDARY ACTORS WILL RESULT IN INADEQUATE COMPENSATION FOR INVESTORS

Preventing investors from suing secondary actors that commit fraud will result in both inadequate deterrence and inadequate compensation. Investors frequently cannot obtain fraud damages from issuer firms, which may be insolvent or distressed. *See, e.g.*, Cornerstone Research, *Securities Class Action Settlements: 2006 Review and Analysis* 14 (2007) ("[o]ver 35% of the issuer firms in our sample filed for bankruptcy or had their stock delisted from a major exchange before the class action settlement hearing date"; fact that defendant firm is distressed is associated with a decrease in settlement size), *available at* http://securities.cornerstone.com/pdfs/settlements_2006.pdf; Cornerstone Research, *Post-Reform Act Securities Settlements: 2005 Review and Analysis* 14 (2006) ("Cornerstone, *2005 Review and Analysis*") (30% of issuers sued filed for bankruptcy or had their stock delisted), *available at* http://securities.cornerstone.com/pdfs/settlements_2005.pdf. The list of frauds following which investors were able to recover nothing from issuers, with the bulk of

any compensation – usually pennies on the dollar – necessarily coming from secondary actors, is long. It includes, among others, Enron,[9] Global Crossing,[10] Adelphia,[11] Delphi,[12] Refco,[13] and Sunbeam.[14]

Moreover, as both Congress and the SEC have repeatedly recognized, SEC enforcement is not sufficient to deter wrongdoers and to compensate investors. *See, e.g.*, H.R. Conf. Rep. No. 104-369, at 31 (private litigation is "an indispensable tool with which defrauded investors can recover their losses" and is crucial "to the integrity of American capital markets"), *reprinted in* 1995 U.S.C.C.A.N. 730. The SEC does not possess the resources to prosecute most instances of securities fraud. *See, e.g.*, Prepared Testimony of Arthur Levitt, SEC Chairman, and Isaac C. Hunt, SEC Commissioner, *The Securities Litigation Uniform Standards Act of 1997: Hearing on S. 1260 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 105th Cong. (Oct. 29, 1997) ("Private actions are an especially important supplement to the Commission's enforcement program today because of the phenomenal growth of the securities industry during a time when the Commission's staff and budget levels have remained relatively constant."), *available at* http://banking.senate.gov/

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[9] *See* Bill Hensel, Jr., *Settlement adds $2.4 billion to the kitty*, Houston Chron., Aug. 3, 2005, *available at* http://www.chron.com/disp/story.mpl/special/enron/3293828.html.

[10] *See* Gretchen Morgenson, *Global Crossing Settles Suit on Losses*, N.Y. Times, Mar. 20, 2004, at C1.

[11] *See Deloitte and Banks to Pay $455 Million to Adelphia Investors*, N.Y. Times, Dec. 9, 2006, at C4; Geraldine Fabrikant, *Rigas Family To Cede Assets To Adelphia*, N.Y. Times, Apr. 26, 2005, at C1.

[12] *See* Nick Bunkley, *S.E.C. Sues Ex-Officials Of Delphi*, N.Y. Times, Oct. 31, 2006, at C1.

[13] *See* Michael J. de la Merced, *Finance Chief Of Refco Is Indicted*, N.Y. Times, Oct. 25, 2006 at C3; *Austrian Bank To Pay Millions In Refco Case*, N.Y. Times, June 6, 2006, at C3.

[14] *See* 2002 GAO Report at 204-06.

97_10hrg/102997/witness/sec.htm; Testimony of Richard C. Breeden, SEC Chairman, *Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 102d Cong. 15-16 (Oct. 2, 1991) (SEC is able to prosecute only a fraction of the cases in which investors have suffered losses).[15]

Even when the SEC brings an enforcement action, it often recovers only a fraction of what private lawsuits yield for investors. *See* Cornerstone, *2005 Review and Analysis* at 13, Fig. 12. For example, in the WorldCom litigation, the SEC obtained $750 million for investors, while the related class action obtained $6.2 billion, *see id.*; in the Cendant litigation, the SEC failed to recover any significant amount for investors, while private suits recovered $3.2 billion, *see In re Cendant Corp. Litig.*, 264 F.3d 201, 217 (3d Cir. 2001).[16]

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[15] *See also* Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 Vill. L. Rev. 1139, 1161 (2003) ("Unless there is a vastly enlarged SEC, private actions inevitably must serve as an enforcement substitute for deterrence purposes, as well as their more traditional role as an avenue for appropriate compensation of victims."); Report of the SEC: Section 703 of the Sarbanes-Oxley Act of 2002 – Study and Report on Violations by Securities Professionals 5 (Jan. 2003) (SEC brought only 13 aiding-and-abetting actions against securities professionals in calendar years 1998 through 2001), *available at* http://www.sec.gov/news/studies/sox703report.pdf.

[16] Nor is the ability to file an individual state-law action against a secondary actor, which would not be preempted by SLUSA, an adequate substitute for the ability to file a class action under federal or state law. Even institutional investors often do not have enough at stake with respect to a particular issuer to warrant the expense of an individual lawsuit. Moreover, for many ordinary shareowners, the denial of class relief would mean no relief at all. As the Court has recognized, "'[t]he policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights.'" *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 617 (1997) (quoting *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (7th Cir. 1997)).

CONCLUSION

For the foregoing reasons, the Court should not adopt the strict test for primary liability based on policy considerations. Such a test would provide a safe harbor to secondary actors who manage to commit fraud without announcing their involvement to the public. It would not only deny compensation to defrauded investors, but also undermine ongoing efforts, in the aftermath of devastating financial scandals, to strengthen the role of secondary actors in maintaining the integrity of the securities markets.

Respectfully submitted,

JEFFREY P. MAHONEY
COUNCIL OF INSTITUTIONAL INVESTORS
888 17th Street, N.W.
Suite 500
Washington, D.C. 20006
(202) 822-0800

MARK C. HANSEN
PRIYA R. AIYAR
Counsel of Record
KELLOGG, HUBER, HANSEN, TODD, EVANS & FIGEL, P.L.L.C.
1615 M Street, N.W.
Suite 400
Washington, D.C. 20036
(202) 326-7900

Counsel for Amicus Council of Institutional Investors

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